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SUBJECT: ECB Staff Projections: Growth to Pick Up in 2004 -
Forecasting External Sector Is Tricky Business

T-IA-F-03-0066

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¶1. (SBU) Summary: The European Central Bank's (ECB's) December staff projections suggest real Euro area annual average growth of 0.4% in 2003 rising to 1.6% in 2004 and 2.4% in 2005. The basic story is that exports will help lift growth in the near term followed by a strengthening of domestic demand, particularly private consumption. The staff projections carry a larger range of uncertainty for exports and imports, understandably so given the euro's appreciation against the USD. While a "rule of thumb" would suggest an appreciating euro could be, on balance, a drag on EU growth, the strong pick up in US demand suggests that the negative growth effects may not be as strong as the "rule" implies - at least in the near term. End Summary

ECB Staff Projections

¶2. (SBU) In its December monthly bulletin the ECB presented current staff projections for macroeconomic developments in the euro area. The ECB, which expresses its growth projections in terms of "ranges," adjusted expected GDP growth downwards for 2003, slipping the mid-point of the projection ranges from 0.7% to 0.4%. This adjustment is due to a weaker than expected outcome in the second quarter. However, they left the growth projection for 2004 unchanged, with a mid-point of 1.6%. In their view, the impact of the announced expansionary fiscal measures in the euro area is limited, as the increase of households' real disposable income due to tax cuts is expected to be counterbalanced by higher consumer prices. For 2005 projections show the mid-point of the growth range rising to 2.4%.

¶3. (SBU) Inflation, as measured by the Harmonized Index of Consumer Prices (HICP) is expected to be around 2.1% in 2003. However, the staff shifted upward the range projected for the HICP in 2004 from a mid-point of 1.3% to 1.8%, compared to their last forecast in June. The increase is due to various planned fiscal measures, such as increases in indirect taxes and administered prices, as contained in national budget plans.

¶4. (SBU) The staff projections are based on the following main assumptions:

short-term interest rates are constant over the projection horizon at slightly below 2.2%;
EUR/USD exchange rate assumed to be constant at 1.17 over the horizon;
Annual average oil prices assumed to decline from 28.5 USD per barrel in 2003 to 24.5 USD in 2005;
World real GDP growth outside euro area estimated at 4% on average in 2003, increasing to 4.5% in 2004 and 5% in 2005;

ECB projections,
y/y in %

December 2003

	2002	2003	2004
		2005	
Real GDP	0.9	0.2 - 0.6	1.1 - 2.1
	0.5	1.9 - 2.9	
	2.8	1.0 - 1.4	1.1 - 2.1
		1.4 - 3.0	
	-2.8	0.9 - 2.1	0.6 - 1.6
		0.3 - 1.3	
	1.7	-1.7 - -0.7	0.2 - 3.2
	0.0	2.3 - 5.5	
	2.3	-1.6 - 1.2	2.8 - 6.0
		5.0 - 8.2	

	0.1 - 2.7 5.1 - 8.5	2.9 - 6.3
	2.0 - 2.2 1.0 - 2.2	1.3 - 2.3
Private Consumption		
Government Consumption		
Gross fixed Capital Formation		
Exports (goods & services)		
Imports (goods & services)		
HICP		

Real GDP Growth Projection

15. (SBU) The ECB expects only a weak GDP growth between 0.2 and 0.6% for 2003 (mid-point of 0.4%), since in the first half of the year real GDP stagnated in the euro area. For 2004 and 2005, they project an acceleration of GDP growth, reaching values between 1.1 and 2.1% (mid-point of 1.6%) and 1.9 and 2.9% (mid-point of 2.4%), respectively. Economic development will be characterized by a pick-up in export growth and recoveries in both investment and private consumption. The ECB expects a significant rise in employment at the earliest in 2005, as reflecting the usual lag in the cyclical pattern of employment.

Price and Cost Projections

16. (SBU) The ECB estimates HICP to be in a range between 2% and 2.2% in 2003. For the following years, the ECB expects lower inflation rates due to the assumed decline in oil prices. Import prices are currently damped by the euro appreciation. They are estimated to remain subdued in 2004, not least because of decreasing energy prices, then passing over to a modest increase in 2004. Unit labor cost growth is forecast to decline in 2004 and 2005, which will be driven by a recovery in labor productivity. After remaining low in early 2003, labor productivity would pick up at the end of 2003, moving back to rates close to the long-term average at the end of the staff projection horizon.

External Sector: Rule of Thumb and Disconnects

17. (SBU) Export and import components always have been difficult to forecast. The wide range of possible outcomes for 2004, i.e., exports to grow between 2.8% and 6.0%, reflects the difference between actual outcomes and past projections. That is, it is a mechanical exercise and does not reflect any judgments on a range of probability by ECB staff. With the euro at 1.21/USD in early December, 4.1% higher than its end-October level and 28% stronger than its 2002 average, according to ECB statistics, forecasting external accounts is even trickier business.

18. (SBU) Although the ECB does not present its forecasting methodology, it has made some specifications of its macroeconomic model available. From this, some market analysts have derived what they consider a "rule of thumb" for computing exchange rate effects on economic developments. Deutsche Bank Research and Lehman Brothers both indicate that, using the ECB's model implies that a 10 percent rise in the real effective exchange rate would knock 0.5 percentage points off inflation and 0.6 percentage points off growth in the first year. While the ECB has suggested that the appreciating euro's contribution to lower inflation would contribute to higher real incomes, these effects appear to be overwhelmed by a negative net trade balance as imports grow while exports struggle.

19. (SBU) To every rule of thumb there are exceptions. To this one there are many. First, in any model there is the economists' favorite "all other things being equal" assumption. That is, the model assumes that there is a "shock" in the exchange rate market rather than changes in underlying economic activity. Reality is different.

110. (SBU) In last year's Article IV consultation, IMF staff examined the Euro area's experience when the euro was weaker. They found an apparent "disconnect" in the exchange rate link with trade flows between the euro and other large currency areas. During 1996-2001 the real effective exchange rate of the euro declined by almost 30 percent. IMF staff compared a simulation using conventional measures of trade elasticities and the linkage between trade flows and exchange rates with actual changes. The simulation results

suggested that non-oil trade surpluses would have increased by 2.3% of GDP as more competitively priced exports would increase (2.9%) and more expensive imports decline (0.6%). Actually, trade balances declined by 0.2% of GDP - a deviation of a whopping 2.5% of GDP as exports increased but so did imports. The IMF staff observed that all other things "have clearly not been equal," pointing to the effects of domestic and foreign absorption growth on trade volumes and the effects of domestic and foreign cost developments on domestic prices. In a more refined calculation, the IMF shows that the "disconnect" was the strongest for capital goods imports, perhaps reflecting a rising share of relatively price-inelastic high tech goods.

¶11. (SBU) IMF staff findings "suggest caution using standard econometric model simulations for gauging the macroeconomic effects of a reversal of the euro's depreciation." Specifically they thought the assumption that the "close-to-one-pass-through" of exchange rate changes to import prices "may no longer match up" for the EMU as a whole.

¶12. (SBU) With much faster growth in the U.S. than Europe, "foreign absorption," to use the IMF's phrase, could mitigate the otherwise price competitiveness effects of an appreciating exchange rate - at least for a while. UBS Investment Research has a crude model that suggests growth in global industrial production is roughly twice as important as changes in the real trade-weight euro in the short run. Given the lags between the increase in demand to translate into exports, UBS expects euro area exports to pick up over the next two (for consumption goods) to six (for investment goods) months. Only when global (read U.S.) demand cools and the euro continues to appreciate would the effects of the latter begin to be more of a drag on export performance. That would be in 2005, in UBS's assessment - by which time the euro area should be running on stronger domestic demand.

¶13. (SBU) Publicly the ECB does not want to be associated with any "rule of thumb" on exchange rates. At his early December appearance before the Economic and Monetary Affairs Committee of the European Parliament, ECB President Trichet refused to be tied down, declaring "we are not the prisoners of a particularly equation or of a particular way of looking at things." Informally, ECB staff admit to such formulas but quickly point out that they are used to provide a "perspective" or "orientation" for discussion. The exchange rate together with external demand and profit margin adjustments and market shares must be taken account to produce a final result. While the formulae are mechanical, other elements, in the end, are subjective.

¶14. (SBU) ECB staff projections and the European Commission's forecast are broadly similar. The Commission forecasts euro area growth at 0.4% in 2003, 1.8% in 2004 and 2.3% in 2005. With respect to the assumptions, both assume a pick up in world growth (EC puts it at 4.1% in 2004 and 2005). The Commission's forecast sees net exports contributing to growth in 2004 and 2005, albeit a slight 0.1 and 0.2 percentage points, respectively. However, both assume a Euro/USD exchange rate of 1.17. Some forecasters see that as unrealistic - implying that the drag of exchange rate appreciation could bite faster when external demand begins to flag. All the more reason for European governments to concentrate on domestic policies to generate confidence and growth.

¶15. (U)This cable coordinated with USEU and Embassy Berlin.

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